COHEN & STEERS

Recession and the roadmap for listed and private real estate

Real estate is being repriced as investors come to grips with a new cost of capital and slowing growth.

by **Jim Corl** and **Jason Yablon**

KEY TAKEAWAYS

Real estate is repricing

Listed real estate is down meaningfully this year, while we expect private real estate values to decline amid decelerating growth, higher financing costs and tighter availability of financing.

Setting up for strong vintage returns

Listed real estate tends to be a leading indicator for private, and we believe this indicates an opportunity for strong returns across both asset classes once the reset occurs.

Secular winners and losers

We also see some notable opportunities emerging amid secular shifts in the real estate landscape, including next-generation real estate, offices and housing in the Sunbelt and "surban communities," and disrupted and stressed properties.

We see the economic regime shift creating the potential for strong vintage returns

The turning of the economic cycle to a decelerating growth or contracted environment, higher financing costs and tighter availability of financing are shifting the private and listed real estate landscape under our feet.

The result, so far this year, is that listed real estate performance has been weighed down by real estate investors' increased expectations for returns. REITs, as measured by FTSE Nareit All Equity REITs Index, are down 25.0% through September 23. This decline is comparable to what we've seen from REITs historically in recessionary periods (see chart).

At the same time, the private real estate markets have not yet repriced to reflect market weakness, but we expect private values to also decline. Private real estate typically lags listed real estate due to its slower-moving price discovery, transactions and process.

We see this backdrop creating a potential opportunity for strong vintage returns in both listed today and private real estate over time once it reprices.

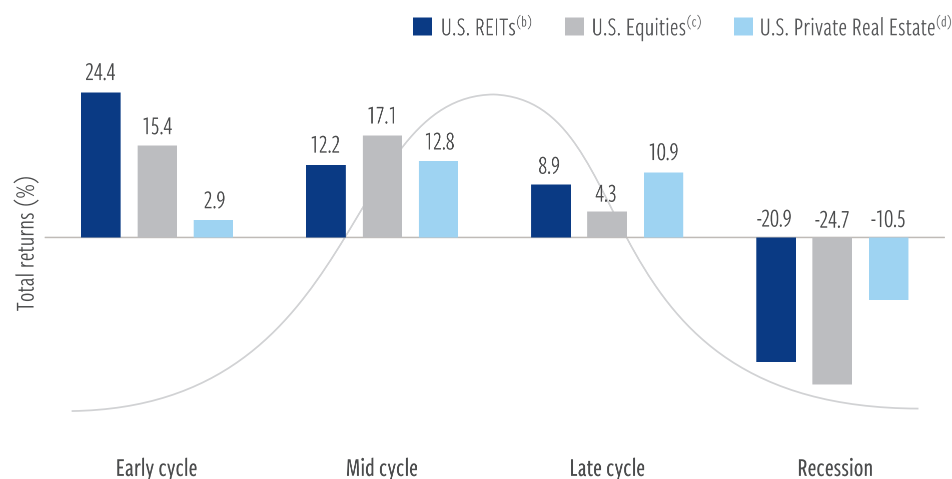
Listed real estate as a leading indicator for private is consistent with history. Listed tends to lead private real estate in both selloff and recovery during recessionary periods. Differences in the real-time pricing of listed REITs and private real estate can create significant short-term dislocations. By understanding the leading and lagging behaviors of listed and private markets, real estate investors may be able to tactically allocate at different times across the two asset classes, seeking to take advantage of how markets have priced in current conditions.

EXHIBIT 1

Listed and private real estate historically impacted by recession but with varying magnitude and lag

January 1991–December 2021

Average total returns based on U.S. conference board indicator[a]



At June 30, 2022. Source: Thomson Reuters Datastream, Cohen & Steers, and Bloomberg.
Index comparisons have limitations as volatility and other characteristics may differ from a particular investment. Private Real Estate returns are lagged by four quarters to adjust for the appraisal process in the private market.
Analysis based on U.S. business cycles as determined by the U.S. Conference Board Coincident Indicator.
(a) The Composite Index of Coincident Indicators is an index published by the Conference Board that is a broad-based measurement of current economic conditions, helping economists and investors to determine which phase of the business cycle the economy is currently experiencing. Months from January 1991-December 2020 have been categorized as early, mid, late cycle, or recession. Above returns show the average annualized return during these periods.
(b) U.S. REITs represented by the FTSE Nareit Equity REITs Index. (c) U.S. Equities represented by the S&P 500 Index. (d) U.S. Private Real Estate is represented by NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE). See page 7 for index associations, definitions and additional disclosures.

This selloff in listed real estate and the expected repricing of private are also consistent with our macroeconomic base case. We believe we are in a recession. Growth has slowed for consecutive quarters to start the year, and while jobs and some other measures still show strength, central banks have embarked on one of the most aggressive rate-hike paths in history, pushing rates higher to forcibly slow down the economy.

We think we are facing an average recession, as measured against recessions over the past 100 years. Our base case is a decrease of 2% to 3% in real global domestic product and a duration of about 12 months.

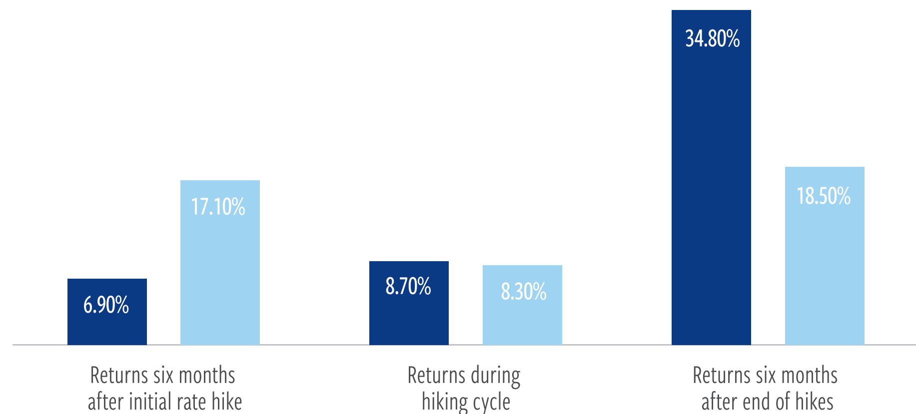
Notably, however, superior returns in real estate tend to follow recessionary periods. The result, emerging from this challenging period, may be some strong vintage returns across both real estate categories. Optimizing a real estate portfolio, however, can be enhanced by integrating both listed and private markets.

Pricing real estate is challenging in an environment where growth rates are decelerating and financing costs are still increasing. That said, valuations in real estate prices, as well as further expected declines in some sectors, should present attractive entry points. But it's not uniform across the board, as different sectors will respond differently to the cyclical challenges and structural changes that are occurring.

EXHIBIT 2

REITs have historically outperformed broader equities following Fed rate hikes

- U.S. REITs
- U.S. equities



At August 31, 2022. Source: Cohen & Steers calculations, Bloomberg, and Federal Reserve.
Data quoted represents past performance, which is no guarantee of future results. The information presented above does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend might begin. Returns represent average of hiking period cycles covering Feb 1994-Mar 1995, July 1999-June 2000, July 2004-Aug 2006, and Dec 2016-Feb 2019.
(a) U.S. REITs are represented by the FTSE Nareit All Equity REITs Index. Returns shown are annualized total returns. (b) U.S. equities are represented by the S&P 500 Index. Returns shown are annualized total returns.

In private real estate, price discovery will take more time. We expect the stress cycle after a period of illiquidity to create opportunities in private real estate for multiple years. Against the backdrop of our base case of an average recession, we expect private real estate values to sell off as much as 15%. A deep recession, though unlikely in our view, could possibly push prices down as much as 25%.

Still, we are expecting a strong vintage on the other side of the downturn. For one thing, owners who failed to capitalize on the availability of long-term cheap debt, or who face a near-term loan maturity, will be forced to contribute equity to maintain control of their assets—otherwise, they may become forced sellers. This creates an ability to generate opportunistic returns by providing equity capital to help refinance assets, or by acquiring assets from lenders that have foreclosed on their borrowers.

Owners may also look to sell their high-quality assets at market-clearing prices to help meet other liquidity needs across their balance sheets. Further, assets may become operationally distressed after a destabilizing event, such as a loss of tenants.

We expect debt markets to continue to tighten as rates rise and financial conditions worsen. Combined with slowing growth, this should be a catalyst for further repricing.

We expect debt markets to continue to tighten as rates rise and financial conditions worsen. Combined with slowing growth, this should be a catalyst for repricing. REIT balance sheets are strong, and they will be able to take advantage of the opportunities this presents.

There are also some specific characteristics for real estate we would buy in this environment (see chart). And we expect real estate's historically durable and predictable cash flows may provide defensiveness relative to other asset classes in the current cycle.

EXHIBIT 3

Attractive characteristics for a counter-cyclical real estate strategy at this stage in the cycle

Defensive	Offensive
High quality assets...	in growth markets
Credit tenants...	paying below market rents
Long lease terms...	with built-in rental increases
Limited new competitive supply dynamic...	at significant discounts to intrinsic value (replacement cost)
Attractive multiples on in-place cashflows...	potential for future cap rate compression
High cash-on-yield potential...	and higher total return potential

Views as of August 31, 2022. Source: Cohen & Steers.

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Real estate has distinct characteristics that can help provide a buffer against inflation.

Single-family rental housing, which is one of our largest listed real estate overweights as of the end of August, could prove resilient as both a defensive and potential secular winner, as young families are compelled to rent more space for longer amid higher cost of ownership and low housing inventory.

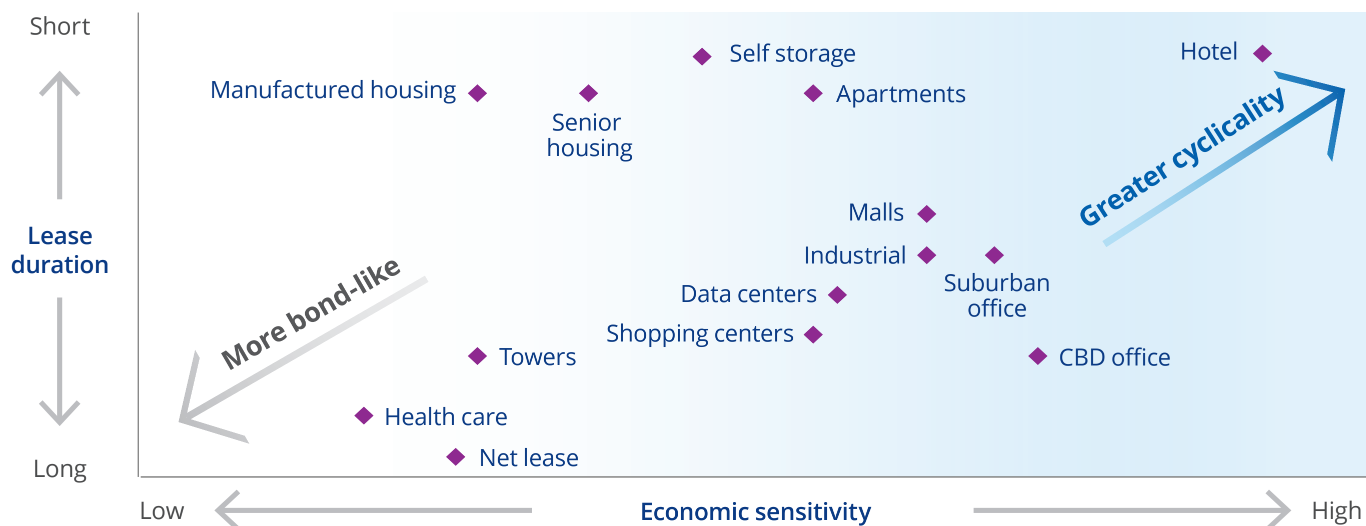
It should also be noted that inflation remains stubbornly high. While inflation may have started to decline from very high levels, we expect it to remain elevated through at least the end of 2023—and even then, inflation should remain above levels seen in the past decade as the forces that drove the previous disinflationary environment abate. We anticipate that the combination of higher commodity prices and housing costs, tighter labor markets, a shift from peak globalization, and shortages of goods and materials across industrial sectors will keep inflation elevated.

Real estate has distinct characteristics that can help provide a buffer against inflation. For example, sectors with shorter lease durations (such as self storage) have the ability to reset rents promptly as conditions change (see chart). In the case of slow growth—or even a recession—longer, inflation-linked rental contracts offer relatively strong and steady income growth potential.

EXHIBIT 4

Lease duration matters through economic cycles

Property types by economic sensitivity and lease duration



At June 30, 2022. Source: Cohen & Steers estimates.
There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend might begin. Based on Cohen & Steers expectations.

Furthermore, higher costs for land, materials and labor have increased replacement costs, reducing the potential profits of development and raising the economic barriers to new supply and reducing potential competition for existing properties. Sectors such as cold storage and senior housing, whose expenses have been driven higher by rising labor costs, may also benefit from moderating labor strength.

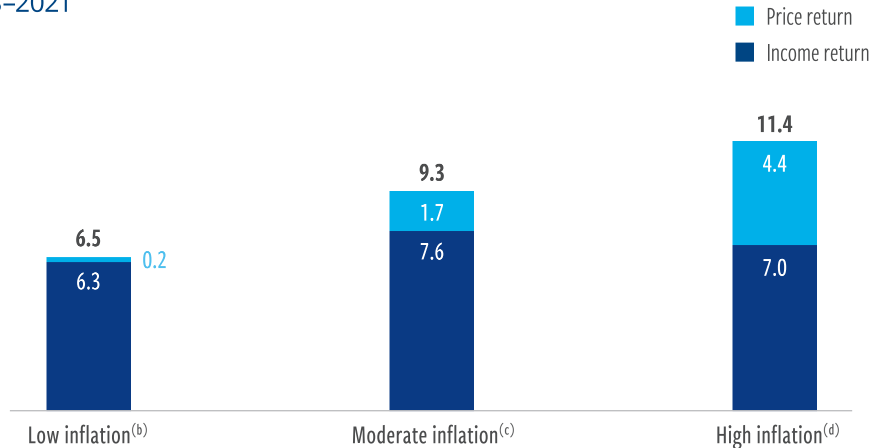
The historically strong performance of real estate during periods of higher inflation (see chart) reflects these characteristics.

EXHIBIT 5

Real estate has historically delivered when inflation is high

Returns during varying periods of inflation (%)[(a)]

1978–2021



At December 31, 2021. Source: NCREIF, Bureau of Labor Statistics and Cohen & Steers proprietary analysis.
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(a) Returns represented by simple average returns of apartment, hotel, industrial, office and retail sectors in the NCREIF Property Index (NPI), which is a quarterly, unleveraged composite total return index for U.S. private commercial real estate properties held for investment purposes only. Sectors are based on NCREIF classifications. Inflation is represented by the consumer price index (CPI), which measures changes in the prices paid by urban consumers for a representative basket of goods and services. (b) Low inflation characterized as years when inflation was less than 2.0% (11 periods). (c) Moderate inflation characterized as years when inflation was between 2.0% and 4.5% (25 periods). (d) High inflation characterized as years when inflation was greater than 4.5% (8 periods). See page 7 for index associations and definitions, and additional disclosures.

While we expect attractive entry points to emerge, current conditions and secular forces will create winners and losers. For instance, the secular forces of changing housing needs, technological innovation and cost-of-living differences are accelerating a migration from high-density, high-tax and high-cost-of-living locations to less crowded, less taxed and less expensive markets.

Millennials are seeking more space and better schools to raise families. Workers are cutting the cord to the office, freeing themselves to live most anywhere. Businesses and city residents are looking to greener and cheaper pastures. These shifts moved faster through the pandemic, but we also think they have more room to run.

We see four notable opportunities related to these trends.

1. **Next-generation real estate.** Technology and other disruptors are transforming this once very traditional asset class into one with many emerging secular winners. The cell tower, health care, data center and logistics sectors offer new opportunities across a diverse range of properties.
2. **Offices and housing in the Sunbelt and "surban" communities.** New communities offering attractive live-work-play environments—with a degree of urban flair and luxury amenities, but with fewer crowds—are capturing maturing millennials and aging baby boomers moving out of high-density cities.
3. **Retail properties as last-mile distribution centers.** In surban locations, major retail tenants operate as online fulfillment centers. As internet-resilient anchors, these properties have the potential to offer better yields than traditional warehouses.
4. **Disrupted and stressed properties.** The dual forces of the pandemic and new migration patterns have disrupted some notable property types and geographies. Meanwhile, financial stress resulting from slowing growth and tightening credit should create early-cycle opportunities.

We believe investors navigating these secular and cyclical shifts will best be positioned in a portfolio which allocates to both listed and private real estate. The precise mix between listed and private will be driven by a series of investor-specific factors, including (but not limited to) the need for liquidity, preference for income versus total return, general risk tolerance, aversion to mark-to-market volatility, and fee sensitivity.

About the authors

James Corl, Executive Vice President, is Head of the Private Real Estate Group. He has 32 years of experience. Mr. Corl rejoined Cohen & Steers in 2020, having previously been with the firm for 11 years, serving as Chief Investment Officer—Real Estate from 2004 to 2008. Most recently, he was head of real estate at Siguler Guff & Company, where he led a real estate investment group focused on private markets. Earlier in his career, Mr. Corl held real estate investment roles at Heitman Capital Management and Credit Suisse First Boston. He has an MBA from the University of Pennsylvania and a BA from Stanford University and is based in New York.

Jason Yablon, Executive Vice President, is Head of U.S. Real Estate and a senior portfolio manager for U.S. real estate securities portfolios and oversees the research process for U.S. real estate securities. He has 22 years of experience. Prior to joining Cohen & Steers in 2004, Mr. Yablon was a sell-side analyst at Morgan Stanley for four years, focusing most recently on apartment and health care REITs. Mr. Yablon has a BA from the University of Pennsylvania. He is based in New York.

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